State of Washington Workers' Compensation Funds

July 1, 2012, through June 30, 2013

December 30, 2013

Report number: 1011069

This report summarizes the results of our audit of the Workers' Compensation Program financial statements. The report also summarizes an independent actuarial assessment of the loss reserves and 2014 premium rate changes on the actuarial solvency of the Accident, Medical Aid and Pension Reserve funds.

We found the financial statements for the year ended June 30, 2013 were fairly presented. An independent actuarial firm reported that a reasonable provision had been made for unpaid and estimated claims payable liabilities. Considering the premium rates adopted for 2014, the firm reported further rate increases may be necessary over the next five year to reduce the risk of insolvency and build the contingency reserves to target levels.

Audit authority

The state's Workers' Compensation Program, administered by the Department of Labor & Industries, provides medical and limited wage replacement coverage to workers who experience job-related injuries and illness.

State law (RCW 51.44.115) requires the State Auditor's Office to annually audit and report on the financial statements of the program. The law also requires the Auditor's Office to contract with independent actuaries for actuarial assessments and opinions on three of the Program's funds.

Results in brief

Our examination determined:

- The financial statements for the Workers' Compensation Program for fiscal year ended June 30, 2013, were fairly presented in accordance with generally accepted accounting principles.

The assessments and opinions of the independent actuaries as of June 30, 2013, are:

- Effective January 1, 2014, average combined premium rates for all funds will increase 2.7 percent (Note: rates for the Accident and the Medical Aid funds will increase 3.7 percent.) The 2014 premium rate for the Accident Fund is more than needed to allow the fund to break even during calendar year 2014. The 2014 rate for the Medical Aid Fund is less than needed to allow the fund to break even during calendar year 2014. However, on a combined basis, the rate changes are within a reasonable range to allow the funds to break even in 2014.
- If the Department were to leave premium rates unchanged from 2015 through 2018, the actuarial firm calculated a 37.1 percent chance the contingency reserve will fall below zero (or become actuarially insolvent, as explained later in the report)* in the combined Accident and Medical Aid funds over the five-year period. The contingency reserve is the difference between a fund's total assets and its total liabilities.
- Considering the 2014 premium rates, if the Department chooses to raise rates from 2015 through 2018 consistent with long-term averages, the actuarial firm believes there is a 13.9 percent chance the contingency reserve will fall below zero in the combined Accident and Medical aid funds over the five-year period.
- Contingency reserves increased slightly during the fiscal year that ended June 30, 2013. However, the reserves, as a percentage of loss and loss adjustment expense reserves, are below levels benchmarked to other workers' compensation state funds.

* Actuarial insolvency is defined as liabilities in excess of the value of assets. It is important to note that actuarial insolvency is not necessarily a key indicator of the funds' ability to pay claims, to have sufficient cash, or the Department's ability to liquidate invested assets to pay obligations over the next several years .

- To build the contingency reserves to a minimum level of 12.5 percent of the loss and loss adjustment expense reserve, the actuaries estimates rate increases of 2.2 percent and 12.1 percent in the Accident Fund and the Medical Aid Fund, respectively, would be required each year from 2015 to 2018. The 12.5 percent benchmark is a lower level of contingency reserves than the current contingency reserves of nearly all other workers' compensation state funds but has been the historical minimum benchmark ratio used in prior actuarial studies.
- The Department has made a reasonable provision in its financial statements for unpaid and estimated claims payable liabilities.

Recommendation

We recommend the Department closely monitor the contingency reserves and adjust premium rates as necessary to maintain the actuarial solvency of the Accident and Medical Aid funds.

About the Workers' Compensation Funds

The state's Workers' Compensation Program provides medical and limited wage replacement coverage to workers who experience job-related injuries and illness. The Workers' Compensation Program Basic Plan consists of three funds:

- The Medical Aid Fund pays for medical care and related services, including some vocational rehabilitation.
- The Accident Fund pays non-medical claim costs such as wage replacement benefits, most vocational rehabilitation, disability pensions and survivor benefits.
- The Pension Reserve Fund pays benefits to permanently disabled pensioners, including disabled employees of self-insured employers and survivors of fatally injured workers.

Workers' Compensation has four funds that are not required by law to be included in the scope of our actuarial review. They are the Supplemental Pension Fund, Second Injury Fund, Self-Insured Employer Overpayment Reimbursement Fund, and the Industrial Insurance Rainy Day Fund.

In 2011, the state enacted significant reforms to the program. Legislation created a structured settlement option, a Stay at Work Program, and a statewide medical provider network, and expanded the Center of Occupational Health and Education, which treats injured workers. The legislation also temporarily froze cost-of-living increases and made other changes designed to reduce the system's overall costs. According to the independent actuarial firm, the process the Department used to estimate cost savings appeared reasonable given the uncertainty associated with the reforms and the favorable outcomes in other states. Savings from the structured settlement option have been significantly less than expected and estimated savings related to this component of the reform have been reduced by 75 percent.

The Workers' Compensation program bases the amount of its claims payable liabilities on estimates of the cost of claims reported but not resolved, and injuries that have not been reported that will result in claims.

The Department's director sets premium rates after considering information from the Workers' Compensation Advisory Committee, the Governor, the public, interest groups, and the Department's actuaries. For calendar year 2013, the state's employers will pay an expected average hourly premium rate of $0.628. Under state law, employers may require employees to pay a portion of the total premium.

The State Investment Board invests the money in these funds under policies and procedures designed to maximize return at a prudent level of risk. Eligible investments include U.S. equities, international equities, U.S. treasuries and government agencies, credit bonds, mortgage-backed securities, asset-backed securities, and non-U.S. dollar bonds. Investment allocation targets are shown in the table below.

Investment allocation targets

Fund	Fixed income	Treasury inflation protected securities	Equity
Accident	80%	10%	10%
Medical Aid	65%	20%	15%
Pension Reserve	80%	10%	10%

Audit overview

We audited the Workers' Compensation Program financial statements in accordance with generally accepted auditing standards. Our financial audit covered the seven funds noted above.

As required by state law, we contracted with an actuarial firm for actuarial assessments of the loss reserves in the Accident, Medical Aid, and Pension Reserve funds. The firm also assessed the financial effect of the 2014 rate changes on the actuarial solvency of these funds, taking into consideration the risks inherent with insurance and the effect of the actuarial assumptions, discount rates, reserving, retrospective rating program, refunds, and individual employer rate classes, as well as the standard accounting principles used for insurance underwriting purposes.

We selected the actuarial firm through a competitive solicitation of independent qualified firms. The leader of the actuarial team is a member of the American Academy of Actuaries and a Fellow of the Casualty Actuarial Society, and meets qualification standards for statements of actuarial opinion.

Audit results

Financial statement opinion

We issued an unqualified opinion, concluding that the financial statements of the Workers' Compensation Program of the State of Washington for the fiscal year ended June 30, 2013, were fairly presented in accordance with generally accepted accounting principles. The financial statements can be seen at: **www.lni.wa.gov/ClaimsIns/Insurance/Learn/StateFund/Reports/Default.asp**

Actuarial opinion on loss reserves

The actuarial firm issued an opinion stating the reported loss and loss adjustment expense reserves are consistent with reserves computed in accordance with Standards of Practice issued by the Actuarial Standards Board. The firm concluded the reserves make a reasonable provision for all unpaid loss and loss adjustment expense obligations of the Workers' Compensation Program.

Assessment of the financial impact of the 2014 rate level

As shown in the table below, contingency reserves increased slightly during the fiscal year that ended June 30, 2013, but remain at historically low levels and below the Department's target. The contingency reserve is the difference between the fund's total assets and its total liabilities. It is important to maintain adequate reserves to cover unexpected losses, as well as shortfalls in premium and investment income.

Contingency reserve presented under statutory accounting principles
Dollars in thousands

Fund	June 30, 2007	June 30, 2008	June 30, 2009	June 30, 2010	June 30, 2011	June 30, 2012 (Restated)	June 30, 2013
Accident	$841,004	$776,052	$69,638	($358,125)	$63,250	$34,599	$202,841
Medical Aid	$1,252,708	$825,894	$480,583	$539,335	$716,119	$545,771	$416,721
Pension Reserve	$2,093,712	$1,601,946	$550,221	$181,210	$779,369	$580,370	$619,562

The reduction in contingency reserves from June 30, 2007, levels can be attributed to:

- A Medical Aid Fund rate holiday reduced premiums in 2007.
- For several years, premium rates were held down below costs to help employers during the recession.
- Investment earnings were less than expected due to the downturn in the stock market.
- Interest rates used to discount benefit liabilities were decreased due to falling yield on five-year average of U.S. 20-year Treasury bond.
- Claim liabilities adjustments were higher than expected.
- In some years, the Department elected to adopt premium rates that were lower than rates recommended by their actuaries.

Overall premium rates will increase by 2.7 percent in 2014. Unlike other states, premiums are based on hours worked, rather than payroll costs. With wage inflation, other state funds are likely to experience premium growth without rate increases. In order to experience similar premium growth in Washington, higher rates may be adopted to keep up with wage inflation. The table below shows expected average 2014 premium rates and changes from 2013.

Expected average 2014 premium rates and changes from 2013

Fund/Program	Hourly rate	Percent change
Accident Fund	$0.3435	0.0%
Medical Aid Fund	$0.2039	10.6%
Stay at Work Program	$0.0069	(8.6%)
Supplemental Pension Fund	$0.0908	(1.9%)
Total	**$0.6451**	**2.7%**

If the Department were to leave premium rates unchanged from 2015 through 2018, the actuarial firm estimates a considerable probability that the combined funds would become insolvent (contingency reserve less than zero) at the end of the five-year period. The table below shows the firm's estimates.

Probability of insolvency – No rate change
(contingency reserve below zero)

Fund	Two-year horizon	Three-year horizon	Five-year horizon
Accident	18.7%	18.3%	16.9%
Medical Aid	23.8%	40.3%	76.6%
Pension Reserve	15.1%	21.6%	37.1%

Considering the 2014 adopted rates, and if the Department chooses to raise rates from 2015 through 2018 consistent with long-term averages, the actuarial firm estimates that there is a potential that the rate changes will be insufficient to keep the combined funds solvent (contingency reserve greater than zero) at the end of the five-year period. The long-term annual average rate change was based on rate changes adopted by the Department since January 1, 2001. The table below shows the firm's estimates.

Probability of insolvency, long-term average rate changes
(contingency reserve below zero)

Fund	Assumed long-term average annual rate change 2015-2018	Two-year horizon	Three-year horizon	Five-year horizon
Accident	4.3%	17.6%	14.2%	6.6%
Medical Aid	5.8%	23.2%	33.4%	50.6%
Combined Accident and Medical Aid funds		**13.8%**	**15.8%**	**13.9%**

The actuarial firm also calculated the projected rate increases that would be necessary to build the contingency reserves to a targeted contingency-reserve-to-loss and loss-adjustment-expense reserve ratio of 12.5 percent at the end of five years. The current reserve ratio, as of June 30, 2013, was 4.9 percent. The target reserve ratio of 12.5 percent is a lower level of contingency reserves than the current contingency reserves of nearly all other workers' compensation state funds, but has been the historical minimum benchmark ratio used in prior actuarial studies. The ratio was initially based on a survey of other workers' compensation state funds contingency reserves at the time and selecting the lowest among state funds in the study. To reach this target, the actuarial firm estimates required rate increases each year from 2015 to 2018 to be 2.2 percent and 12.1 percent annually in the Accident Fund and the Medical Aid Fund, respectively.

Actuarial insolvency is defined as liabilities in excess of the value of assets. It is important to note that actuarial insolvency is not necessarily a key indicator of the funds' ability to pay claims, to have sufficient cash, or the Department's ability to liquidate invested assets to pay obligations over the next several years .

The actuarial firm said the probability that the funds would not have sufficient cash and/or invested assets to pay benefits over the next 10 years is extremely low. However, the firm concluded that over the much longer term, the funds would run out of cash and/or invested assets without appropriate rate increases. The firm's conclusions are based on a number of assumptions regarding future conditions and events described in detail in the firm's report.

The Pension Reserve Fund does not assess premiums. It is funded through contributions and transfers from the Accident Fund and self-insurers. Typically, the system fully funds each pension annuity when the liability is transferred to the Pension Reserve Fund. Because of the way the pension reserve fund is financed, its solvency is guaranteed as long as the Accident Fund and the self-insurance program remain solvent.

The actuarial firm also calculated the rate level change that would be required for the funds to break even. This is defined as the point in which zero profits are expected to be generated in calendar year 2014 and the funds' contingency reserves remain unchanged. At the break-even rate level, the estimated revenues would equal the expected cost of claims and administrative expenses that occur during the year.

The firm's best estimate is that a 9.2 percent rate decrease would be necessary for the Accident Fund to break even. The firm's best estimate is that a 23.7 percent rate increase would be necessary for the Medical Aid Fund to break even.

Break-even range level changes: estimated and actual rates

Fund	Actuarial firm's best estimate of the rate level change required to break even	Department's actual 2014 rate change
Accident	(9.2%)	0.0%
Medical Aid	23.7%	10.6%
Combined Accident and Medical Aid funds	**2.3%**	**3.7%**

The Department's adopted rate changes for the individual funds fell outside the actuarial firm's estimated reasonable range required to break even. However, on a combined basis, the rate changes were within the firm's estimated reasonable range to break even.

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